Consumer Federation of America

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On

HURRICANE KATRINA'S EFFECT ON GASOLINE SUPPLY AND PRICES

Committee on Energy and Commerce

U.S. House of Representatives

September 7, 2005

Mr. Chairman and Members of the Committee,

My name is Mark Cooper. I am Director of Research at the Consumer Federation of America (CFA). CFA is a non-partisan, non-profit association of 300 pro-consumer groups, which was founded in 1968 to advance the consumer interest through advocacy and education. We have been analyzing the petroleum industry for decades and have issued numerous reports in the past five years, as the seeds of the underlying conditions for the current crisis became apparent.[1] I greatly appreciate the opportunity to share our views with the Committee today.

Public policy cannot prevent accidents or catastrophic acts of nature, but it can build systems that are resilient, robust and flexible to minimize the impact of the inevitable accidents on our society. It is evident that the business practices of the oil industry and public policy in this country have combined to allow a gasoline industry that cannot respond to even minor incidents, not to mention the disaster that struck the Gulf Coast last week. If the measure of performance of an economic sector is adequate supplies at stable prices, then this industry has failed the consumer, not just in the wake o Katrina, but also repeatedly over the past five years.

The bulk of my testimony today presents word-for-word the policy conclusions that we reached in a report released over four years ago. After analyzing the structure, conduct and performance of the oil industry, we urged policymakers to move aggressively in five areas.

- Restore reserve margins by developing both efficiency (demand-side) and production (supply-side).
- Increase market flexibility through stock and storage policy.
- Discourage private actions that make markets tight/or exploit market disruptions by countering the tendency to profiteer by withholding of supply.
- Promote a more competitive industry.
- Address the disproportionate burden that rising energy price place on lower income households.

Unfortunately, these policy recommendations were not included in any significant way in the recent energy legislation and actions by Federal agencies. For example, the single most important mid- and long-term policy we advocated, improving the fuel efficiency of the vehicle fleet, could have taken significant pressure off of gasoline markets, if it had been embraced four years ago. In the past four years, gasoline consumption in America increased by about 6 percent.

[1] I have submitted for the record four reports on the oil and gas industry that we have prepared over the past four yours. Our policy discussion from the first of these in July 2001 are included as part of this statement.

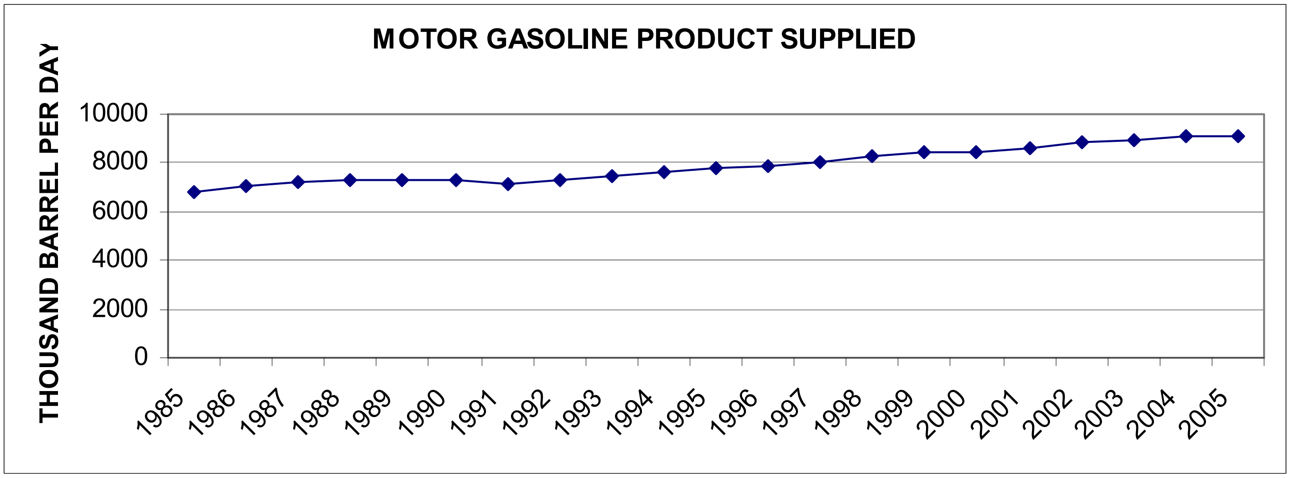
Regrettably, just last month the Department of Transportation proposed timid improvement in fuel efficiency standards, gerrymandered the calculation to let more gas guzzlers escape scrutiny, and exempted some of the worst gas guzzler from fuel consumption standards altogether. Simultaneously, it threatened to preempt states like California from imposing stricter standards. That proposal, which would take ten years to lower consumption by the equivalent of less than what we use in one month, does not address the problem in any meaningful sense.

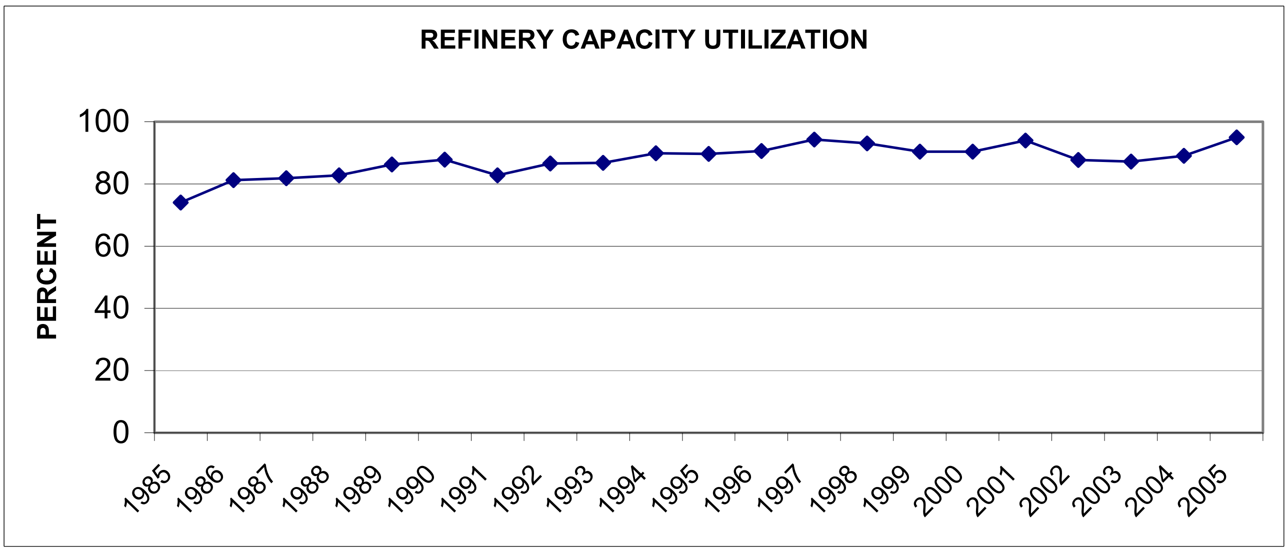
Similarly, the key short-term policy we recommended of increasing reserve margins and stocks has been neglected. I have attached to my testimony three updated graphs from our July 2001 analysis. The first shows gasoline consumption. The second shows refinery capacity compared to demand and the second shows gasoline stocks above minimum operating levels. Together these show that we were living on the razor's edge, with rising demand, little excess capacity and small stockpiles. Katrina pushed us off the edge.

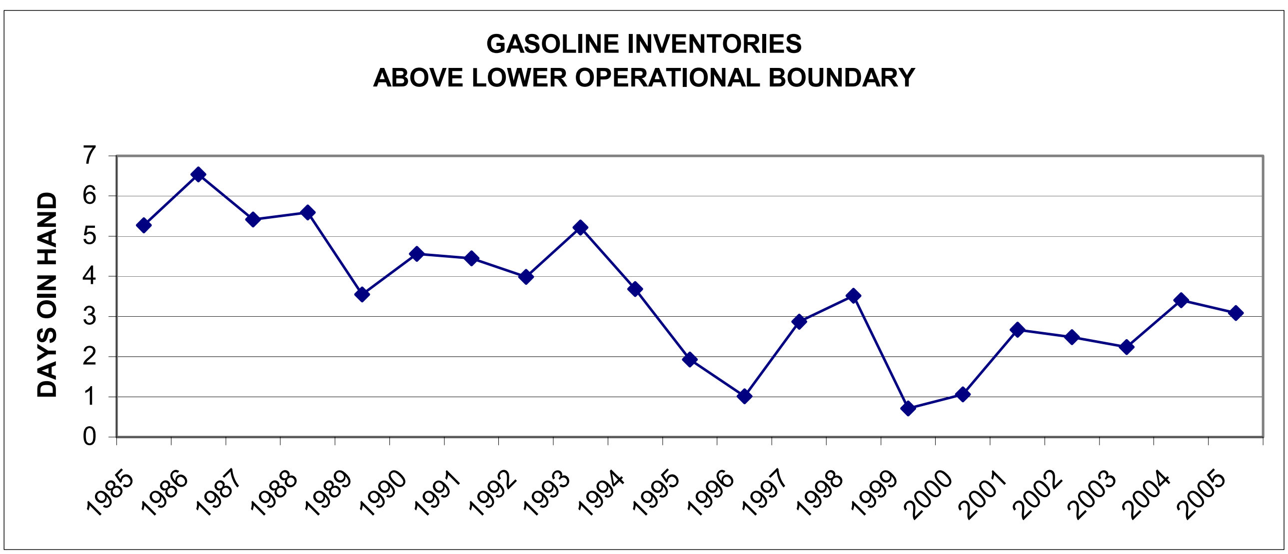
Hurricane Katrina is just the latest in a series of accidents and interruptions that have hit the oil industry and consumers hard. It is the worst possible single event one could imagine from the point of view of the domestic gasoline sector. Yet, its impact reflects the same underlying problems that have afflicted the industry for the past half-decade. At the start of each price spike in the past few years we hear the same refrain. "Stocks were low, refinery capacity was stretched to the limit." A refinery fire here, a pipeline breach there, or a storm triggers a spike.

Once may be a surprise; twice may be bad luck; but by the third time, it is a pattern that demands a systematic response, not hand wringing. Moreover, if many different accidents keep happening, if many different things can go wrong, and if running an overtaxed system makes outages more likely, it is incumbent upon policy makers to do something about it. The industry and public policy have failed to create a system that can meet the needs of the American consumer and America as a nation is paying the price for that inaction.

It is time for a dramatic change in the approach to policy. I offer the same advice we gave four years ago. The only thing I would change is the urgency in the recommendations. We should move twice as fast and set our goals twice as high because past inaction has made the problem we face even more critical.







Source: Department of Energy.

ENDING THE GASOLINE PRICE SPIRAL
MARKET FUNDAMENTALS FOR CONSUMER-FRIENDLY POLICIES TO STOP THE WILD RIDE

July 2001

V. POLICY RESPONSES

A. ECONOMIC FUNDAMENTALS AND POLICY PRINCIPLES

Public policy responses must reflect physical and economic reality. Since the laws of physics cannot be repealed, public policy must be cognizant of the increased likelihood and severe impact of accidents in energy industries, like refineries and pipelines. Physical and institutional structures must be prepared to deal with accidents in this industry.

The low short run elasticity plays a critical role in price volatility and the exercise of market power. The extremely low elasticity of demand is one of the key characteristics of the gasoline market. Suppliers are well aware of the rigidities in the market and can take advantage of them under the right circumstances. Because the gasoline market is so large, even small and short term pricing abuse imposes substantial costs on the public.

Under these circumstances, firms with relatively small market shares can increase profits by withholding supplies, unless the elasticity of supply is high. Unfortunately, petroleum product markets do not exhibit very elastic supply. Reserve margins and stocks are crucial.

1. Supply

Avenues for increasing supply are available, but they may not be pursued, if left to industry business decisions. Since short-term elasticities are quite low, a variety of resources that can be called upon to meet demand quickly are necessary to prevent price volatility. Having reserve margins of production and transport capacity would dampen price volatility. Stockpiles and storage are the best option when demand shifts or supply is interrupted. Import of product is an important option when refinery capacity is not available or, depending on geographic location, when pipeline capacity is not available.

The recent closure of refineries also suggests an avenue for expanding capacity. The most readily available path to expanding capacity may be to identify existing facilities that have been shuttered, or sites that have been recently abandoned to expand capacity while minimizing environmental impact should be explored. Each of these options should be considered, particularly in markets where capacity is tight and ownership is concentrated.

The behavior of small refiners in response to the elimination of programs that supported their existence makes it clear that public policy can affect the number and geographic distribution of refinery capacity. If we want geographically dispersed refinery capacity to promote local responses to supply problems, we just have to pay for it.

2. Demand

In the long run, reducing the size of the market, without imposing deprivation on consumers, is the major policy challenge.

The consumption patterns deeply embedded in spatial relationships lead us to conclude that increased fuel economy is the more readily achievable approach to reducing gasoline consumption than changing living patterns. Reducing fuel use per vehicle allows existing mobility patterns to be preserved, while consumption is reduced.

Shifting preferences for vehicles (toward higher efficiency vehicle types) requires greater change in social behaviors. It is also vulnerable to changes in taste. Moreover, it requires a change in the stock over a substantial period of time, perhaps a decade. While policies to affect these behaviors should be pursued, their complexities and difficulties should be recognized.

Attempting to overlay mass transit on existing living patterns may be pursued as a long-term strategy. However, given consumer preferences and the spatial distribution of activity, this is a substantial task. The increasing suburbanization of living patterns frequently results in relatively low densities and high costs for mass transit. Changing the geographic distribution of work, home and play, requires the greatest amount of social change.

3. Distributional Effects

Equity impacts of rising energy prices, particularly as they affect low and lower middle income households, must be dealt with directly. Neither general tax cuts nor existing energy assistance programs, such as the Low Income Home Energy Assistance Program (LIHEAP), address the problem of rising or volatile transportation energy costs. Even if it could be argued that LIHEAP addresses the general energy needs of groups, ad hoc efforts to increase programs like LIHEAP tend to fall short and come long after the impacts of rising energy prices have been felt.

B. POLICY TARGETS

It is time for public policy to seek permanent institutional changes that both reduce the chances that markets will be tight and reduce the exposure of consumers to the opportunistic exploitation of markets when they become tight. To achieve this reduction of risk public policy should be focused on achieving five primary goals.

- Restore reserve margins by developing both efficiency (demand-side) and production (supply-side).
- Increase market flexibility through stock and storage policy.
- Discourage private actions that make markets tight/or exploit market disruptions by countering the tendency to profiteer by withholding of supply.
- Promote a more competitive industry.
- Address the disproportionate burden that rising energy price place on lower income households.

1. Expand Reserve Margins By Striking A Balance Between Demand Reduction and Supply Increases

We have earlier identified the hierarchy of policies to reduce demand. Increasing the fuel efficiency of the fleet through increased standards for mileage and use of hybrid vehicles should be given top priority. Shifting preferences for vehicle types and modes of transportation through taxes and incentives are a second category to be considered.

A goal of achieving an improvement of vehicle efficiency (reduction in fleet average miles per gallon) equal to economy wide productivity over the past decade (when the fleet failed to progress) would have a major impact on demand. It would require the fleet average to improve at the same rate it did in the 1980s. It would raise average fuel efficiency by five miles per gallon, or 20 percent. This is a mid-term target. This rate of improvement should be sustainable for several decades. This would reduce demand by 1.5 million barrels per day. This would return consumption to the level of the mid-1980s.

Expanding refinery capacity by 10 percent equals approximately 1.5 million barrels per day. This would require 15 refineries, if the average size equals the refineries currently in use. This is less than one-third the number shut down in the past ten years and less than one quarter of the number shut down in the past fifteen years. Alternatively, a ten percent increase in the size of existing refineries, which is the rate at which they increased over the 1990s, would do the trick, as long as no additional refineries were shut down.

Placed in the context of redevelopment of recently abandoned facilities or expansion of existing facilities, the task of adding refinery capacity does not appear to be daunting. Such an expansion of capacity has not been in the interest of the businesses making the capacity decisions. Therefore, public policies to identify sites, study why so many facilities have been shut down, and establish programs to expand capacity should be pursued.

Once the magnitude of the task on the supply-side is placed in perspective, and given the objective analysis of the environmental costs involved, the call to overturn environmental laws loses its force. It seems that expansion of supply-side capacity can be accomplished within the current confines of environmental laws. To the extent that the costs of compliance can be demonstrated to be a significant problem, then underwriting compliance (directly through financial subsidies or indirectly through research) rather than relaxing standards should be pursued.

This combination of demand-side and supply-side policies to improve the long run market balance would restore the supply/demand balance to levels that typified the mid-1980s.

2. Expanding Storage And Stocks

It has become more and more evident that private decisions on the holding of stocks will maximize short term private profits to the detriment of the public. Increasing concentration and inadequate competition allows stocks to be drawn down to levels that send markets into price spirals. While the strategic petroleum reserve has been developed as a strategic stockpile and companies generally take care of operating stocks, the marketplace is clearly not attending to economic stockpiles. Companies will not willingly hold excess capacity for the express purpose of preventing price increases. They will only do so if they fear that a lack of supply or an increase in brand price would cause them to lose business to competitors who have available stocks. Regional gasoline markets appear to lack sufficient competition to discipline anti-consumer private stock policies.

Public policy must expand stocks. Participants in the distribution of gasoline can be required to hold stocks as a percentage of retail sales. Public policy could also either directly support or give incentives for private parties to keep storage. It could lower cost of storage through tax incentives by draw down stocks during seasonal peaks. Finally, public policy could directly underwrite stockpiles. We now have a small Northeast heating oil reserve. It should be continued and sized to discipline price shocks, not just prevent shortages. Similarly, a Midwest gasoline stockpile should be considered.

3. Taking The Fun And Profit Out Of Market Manipulation

In the short term, government must turn the spotlight on business decisions that make markets tight or exploit them.

Withholding of supply should draw immediate and intense public scrutiny. It needs to be backed up with investigations. Since the federal government is likely to be subject to political pressures not to take action, state government should be authorized and supported in market monitoring efforts. A joint task force of federal and state attorney's general could be established on a continuing basis. The task force should develop databases and information to analyze the structure, conduct and performance of gasoline markets.

As long as huge windfall profits can be made, private sector market participants will have a strong incentive to keep markets tight. The pattern of repeated price spikes and volatility has now become an enduring problem. Because the elasticity of demand is so low – because gasoline is so important to economic and social life – this type of profiteering should be discouraged. A windfall profits tax that kicks in under specific circumstances will take the fun and profit out of market manipulation.

Ultimately, market manipulation could be made illegal.

4. Promoting A Workably Competitive Market

Further concentration of these industries is quite problematic. The Department of Justice Merger Guidelines should be rigorously enforced. Moreover, the efficiency defense of consolidation should be looked on skeptically, since inadequate capacity is a market problem.

Restrictive marketing practices, such as zonal pricing and franchise restrictions on supply acquisition should be examined and discouraged. These practices restrict flows of product into markets at key moments.

Markets should be expanded by creating more uniform product requirements. These should not result in a relaxation of clean air requirements.

5. Low-income assistance

Rather than fight repeated battles over supplemental appropriations, it would be more effective to index assistance payments to energy prices. It may be time to consider new programs that deal directly with transportation fuel costs. Transportation energy is a necessity in the 21st century.